

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Contact Person:

199905027

Telephone Number:

In Reference to:

Date:

NOV 3 1998

▷ Significant Index. Nos.

507.00-00
507.04-00
513.00-00
4945.00-00

Legend:

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N=
O=
Q=
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Dear Sir or Madam:

This is in response to a request for certain rulings under sections 501(c)(3), 513, 4940, 4942(j)(3)(A), and 4945 of the Internal Revenue Code (hereafter "Code") submitted on M's behalf by M's authorized representative. M requests the following rulings:

- (1) The activities of M pursuant to its contract with N for O are substantially related to M's exempt purposes and do not adversely affect M's exempt status under section 501(c)(3) of the Code.
- (2) Income earned by M pursuant to its contract with N for O is not subject to tax under section 513 of the Code.
- (3) M meets the requirements as a supporting organization within the meaning of section 509(a)(3) of the Code.
- (4) Expenditures made by M pursuant to its contract with N for O are qualifying distributions within the meaning of section 4942(j)(3)(A) of the Code and accordingly, M will continue to be recognized as an exempt operating foundation within the meaning of section 4940 of the Code.
- (5) Loans made by M pursuant to O's program are not taxable expenditures within the meaning of section 4945(d) of the Code and comply with the requirements of section 4945(g)(3).

M was incorporated on November 29, 1955. M was recognized as exempt under section 501(c)(3) on October 11, 1956. M has been classified as a private operating foundation under section 4940 of the Code. M has submitted notice to the appropriate District Director indicating that it will terminate its private foundation status effective July 1, 1998 and commence operations as a public charity for a 60-month period commencing July 1, 1998.

M's authorizing charter states that its purposes are as follows:

(a) To administer programs of student financial assistance, approved by the Board of Trustees, for the purpose of helping students, parents of dependent students, and spouses of independent students, in defraying educational expenses which may be incurred by students in pursuing courses of study beyond the high school, in public or private educational institutions, in or out of the State of Q, including loans, awards, grants, scholarships and work programs;

(b) to act as agent in the administration of student financial assistance programs for any other corporation, local, state or federal agency approved by the Board of Trustees.

N was established in 1965 and is a political subdivision of the State of Q and serves as Q's education assistance authority. N is authorized, under Q state law, to provide financial assistance to qualified residents of the State of Q to obtain education beyond the high school level by making and insuring student loans, purchasing student loan obligations, and issuing revenue bonds and notes for these purposes.

O was established by Q state statutes as a savings fund to encourage parents and other interested parties to save for postsecondary education. Under state law N is the designated state agency to administer the savings fund program.

Pursuant to a contract with N, M's primary activity is serving as the central loan administrator and servicer for the State of Q's Federal Family Education Loan Program (operated under Part B of Title IV of the Higher Education Act) and State Student Incentive Grant Program (funded under Part A, Title IV of the Higher Education Act, with federal funds and matching state funds). M also originates and services loans under Part B, Title IV of the Higher Education Act, from its own funds. In addition, M acts as a loan administrator and servicer for loans provided by independent banks, financial institutions, education institutions, scholarship programs, and others.

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M states that it provides the following services under its contract with the N:

- (i) the making of guaranteed loans from the proceeds of bonds of issued by the Authority and from any other sources available;
- (ii) the maintenance of and access to full and complete records of guaranteed loans;
- (iii) the safekeeping and custody of promissory notes acquired through the making or acquisition of guaranteed loans;
- (iv) the collection and enforcement of payments of principal and interest with respect to guaranteed loans; and
- (v) the making of claims to the Authority for reimbursement of defaulted principal and interest on such guaranteed loans.

M's charter states that its incorporators and members are the Governor of Q, The Chairman of T's Board of Governors, which succeeded the Board of Higher Education, and the Treasurer of the State of Q. M's affairs are managed by a nine-member board of trustees. Under M's organizing charter Q's Governor has the power to appoint replacement trustees as required.

M proposes to serve as the administrator of O under an agreement with N. N will implement O through a program called R. The R program will consist of a loan component and a savings component.

Participants in the R program will be required to enter into a contract for a named beneficiary. An individual account will be established for each contract in the name of the participant for the named beneficiary. M states that disbursements from the savings program will be made without penalty only for the payment of qualified higher education expenses of the beneficiary or for the exceptional circumstances described in the participants' contracts. The participant or the beneficiary must be a resident of Q at the time the contract is entered into to participate in the program. M represents that it will administer O as N's agent in compliance with all of the requirements for qualified state tuition programs within the meaning of section 529 of the Code. O has not requested a ruling from the Service that it is a qualified state-sponsored tuition program under section 529.

The program is intended to allow parents and other interested parties to save for the postsecondary education expenses of eligible students. M represents that these expenses would include tuition and other qualified higher education expenses, within the meaning of section 529(e)(3) of the Code,

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for students attending public and private colleges and universities.

Participants will also be eligible to receive loans to assist in the payment of the beneficiary's educational expenses. Loan proceeds may only be used to pay the qualified higher education expenses of the beneficiary. The amount of the loan will be no more than the total amount of the savings and earnings on the savings amount under the program.

M will provide the following services as administrator of O for the R program under its contract with N:

(a) Implement and administer the program, including but not limited to: (i) receiving, verifying, and processing all applications for participation in the program; (ii) procuring a contract with each eligible participant; (iii) receiving and accounting for all payments from participants; (iv) depositing such payments with the Q State Treasurer in the name of the N; (v) disbursing funds pursuant to the contracts; (vi) coordinating the disbursements with educational institutions, participants, and beneficiaries as necessary; (vii) conducting credit reviews of participants as appropriate and necessary; (viii) modifying payment plans under the contracts; (ix) conducting appropriate due diligence to collect any delinquent payments under the contracts; and (x) safeguarding the contracts and related promissory notes.

(b) Exercise responsibility for separate accounting support for the program, including but not limited to: (i) individual account maintenance and reporting, coordination and communication with state treasurer or banking institutions based in Q, coordination with N for funds management and maintenance of financial records for the program; (ii) offer the program to potential participants, including distribution of marketing materials as provided and directed by N; (iii) counseling of potential participants to project the costs of a prospective beneficiary's postsecondary education; (iv) identification of the length of each contract and the required monthly payment, and provision for such other information that may benefit participants in planning for the financing of post-secondary education; (v) operate and maintain the necessary computer hardware; (vi) operate a fiscally prudent financial system to ensure the proper maintenance of fiscal records and other financial documents according to the applicable standards of the state auditor, controller, and treasurer, provide access to the program's financial records and system to the state auditor and treasurer, and to the independent

certified accounting firm engaged by N; (vii) cooperate with any consultants or other agents engaged by N with respect to O.

Section 501(c)(3) of the Code provides, in part, that an organization shall be exempt from federal income tax if it is organized and operated exclusively for educational, religious, or charitable purposes, no part of the net earnings of which inure to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(b)(1) of the Income Tax Regulations (hereafter regulations) provides that an organization will be deemed to be organized for such exempt purposes where its articles of organization limit its purposes to one or more of those specified in section 501(c)(3) of the Code, do not expressly provide that the organization may engage, other than to an insubstantial extent, in activities not in furtherance of such exempt purposes, and where its articles permanently dedicate its assets to such exempt purposes.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term 'charitable' is used in section 501(c)(3) of the Code in its generally accepted legal sense, and includes the lessening of the burdens of government.

Rev. Rul. 85-1, 1985-1 C.B. 177, provides that an organization that provides funds to a county's law enforcement agencies to police illegal narcotic traffic lessens the burdens of government and, therefore, qualifies for exemption under section 501(c)(3) of the Code.

Rev. Rul. 85-2, 1985-1 C.B. 178, holds that an organization formed to train and provide legal services to volunteer guardians ad litem qualifies for exemption under section 501(c)(3). The criteria set out in Rev. Rul. 85-2, for determining whether an organization's activities are lessening the burdens of government are: first, whether the governmental unit considers the organization's activities to be its burden; and second, whether these activities actually lessen the burden of the governmental unit. An activity is a burden of the government if there is an objective manifestation by the governmental unit that it considers the activities of the organization to be its burden. The interrelationship between the governmental unit and the organization may provide evidence that the governmental unit considers the activity to be its burden. Whether the

organization is actually lessening the burdens of government is determined by considering all of the relevant facts and circumstances.

Section 509(a)(3) of the Code excludes from the definition of a "private foundation" an organization which is (a) organized and, at all times thereafter, is operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more organizations classified under section 509(a)(1) or (a)(2); (b) is operated, supervised or controlled by, or in connection with one or more organizations described in section 509(a)(1) or (2); and (c) is not controlled, directly or indirectly, by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more section 509(a)(1) or (2) organizations.

Section 511(a)(1) of the Code imposes a tax on the unrelated business income of organizations described in section 501(c)(3).

Section 512(a)(1) of the Code describes the term "unrelated business income" as the gross income derived by an exempt organization from any unrelated trade or business, as defined under section 513, regularly carried on by it, less certain deductions.

Section 513(a)(1) of the Code provides that the term "unrelated trade or business" means, in the case of any organization subject to tax under section 511, any trade or business, the conduct of which is not substantially related, aside from the need of such organization for the income or funds or the use it makes of the profits derived, to the exercise or performance by such organization of its charitable, educational, or other purposes or functions constituting the basis of its exemption under section 501.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income) and is "substantially related," for purposes of section 513 of the Code, only where the causal relationship is a substantial one. In other words, the production of goods or the performance of services from which gross income is derived must contribute importantly to the accomplishment of the organization's exempt purposes.

Section 507(a)(1) of the Code provides that, except as provided in section 507(b), the status of any private foundation shall be terminated only if such organization notifies the

Secretary of its intent to accomplish such termination or, with respect to such organization, there have been either willful or repeated acts or a willful and flagrant act, giving rise to liability for tax under Chapter 42, and the Secretary notifies the organization that because of such act the organization is liable for the tax imposed by section 507(c), and either the organization pays the tax or the entire amount of the tax is abated under section 507(g).

Section 507(b)(1)(B)(i) of the Code provides that the status as private foundation of any organization with respect to which there have not been either wilful repeated acts (or failures to act) or a wilful and flagrant act (or failure to act) giving rise to liability for tax under chapter 42, shall be terminated if such organization meets the requirements of paragraph (1), (2), or (3) of section 509(a) by the end of the 12-month period beginning with its first taxable year which begins after December 31, 1969, or for a continuous period of 60 calendar months beginning with the first day of taxable year which begins after December 31, 1969,

(ii) such organization notifies the Secretary (in such manner as the Secretary may by regulations prescribe) before the commencement of the 12-month or 60-month period (or before the 90th day after the day on which regulations first prescribed under this subsection become final) that it is terminating its private foundation status, and

(iii) such organization establishes to the satisfaction of the Secretary (in such manner as the Secretary may by regulations prescribe) immediately after the expiration of such 12-month or 60-month period that such organization has complied with clause (i).

Section 507(c) of the Code imposes an excise tax on each terminating private foundation equal to the lower of the aggregate tax benefit resulting from such termination or the value of its net assets.

Section 1.507-2(a)(1) of the regulations provides that under section 507(b)(1)(A) a private foundation, with respect to which there have not been either willful repeated acts (or failures to act) or a willful and flagrant act (or failure to act) giving rise to liability for tax under chapter 42, may terminate its private foundation status by distributing all of its net assets to one or more organizations described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)) each of which has been in existence and so described for a continuous period of at least 60 calendar months immediately preceding such distribution. Since section 507(a) does not apply to such a termination, a

private foundation which makes such a termination is not required to give the notification described in section 507(a)(1). A private foundation which terminates its private foundation status under section 507(b)(1)(A) does not incur tax under section 507(c) and, therefore, no abatement of such tax under section 507(g) is required.

Section 1.507-2(b)(2) of the regulations provides that since section 507(a) does not apply to a termination described in section 507(b)(1)(B), a private foundation's notification that it is commencing a termination pursuant to section 507(b)(1)(B) will not be treated as a notification described in section 507(a) even if the private foundation does not successfully terminate its private foundation status pursuant to section 507(b)(1)(B). A private foundation which terminates its private foundation status under section 507(b)(1)(B) does not incur tax under section 507(c) and, therefore, no abatement of such tax under section 507(g) is required.

Section 1.509(a)-4(b)(1) of the regulations provides that under subparagraph (A) of section 509(a)(3), in order to qualify as a supporting organization, an organization must be both organized and operated exclusively 'for the benefit of, to perform the functions of, or to carry out the purposes of' (hereinafter referred to in this section as being organized and operated 'to support or benefit') one or more specified publicly supported organizations. If an organization fails to meet either the organizational or the operational test, it cannot qualify as a supporting organization.

Section 1.509(a)-4(c)(1) of the regulations provides that an organization is organized exclusively for one or more of the purposes specified in section 509(a)(3)(A) only if its articles of organization (as defined in Sec. 1.501(c)(3)-1(b)(2)):

(i) Limit the purposes of such organization to one or more of the purposes set forth in section 509(a)(3)(A);

(ii) Do not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to in subdivision (i) of this subparagraph;

(iii) State the specified publicly supported organizations on whose behalf such organization is to be operated (within the meaning of paragraph (d) of this section); and

(iv) Do not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organizations referred to in subdivision (iii) of this subparagraph.

Section 1.509(a)-4(c)(2) of the regulations provides that in meeting the organizational test, the organization's purposes, as stated in its articles, may be as broad as, or more specific than, the purposes set forth in section 509(a)(3)(A). Therefore, an organization which, by the terms of its articles, is formed 'for the benefit of' one or more specified publicly supported organizations shall, if it otherwise meets the other requirements of this paragraph, be considered to have met the organizational test. Similarly, articles which state that an organization is formed 'to perform the publishing functions' of a specified university are sufficient to comply with the organizational test. An organization which is 'operated, supervised, or controlled by' (within the meaning of paragraph (g) of this section) or 'supervised or controlled in connection with' (within the meaning of paragraph (h) of this section) one or more sections 509(a)(1) or (2) organizations to carry out the purposes of such organizations, will be considered as meeting the requirements of this paragraph if the purposes set forth in its articles are similar to, but no broader than, the purposes set forth in the articles of its controlling section 509(a)(1) or (2) organizations.

Section 1.509(a)-4(e)(1) of the regulations provides that a supporting organization will be regarded as 'operated exclusively' to support one or more specified publicly supported organizations (hereinafter referred to as the 'operational test') only if it engages solely in activities which support or benefit the specified publicly supported organizations. Such activities may include making payments to or for the use of, or providing services or facilities for, individual members of the charitable class benefited by the specified publicly supported organization. A supporting organization may also, for example, make a payment indirectly through another unrelated organization to a member of a charitable class benefited by the specified publicly supported organization, but only if such a payment constitutes a grant to an individual rather than a grant to an organization. In determining whether a grant is indirectly to an individual rather than to an organization the same standard shall be applied as in Sec. 53.4945-4(a)(4) of this chapter. Similarly, an organization will be regarded as 'operated exclusively' to support or benefit one or more specified publicly supported organizations even if it supports or benefits an organization, other than a private foundation, which is described in section 501(c)(3) and is operated, supervised, or controlled directly by or in connection with such publicly supported organizations, or which is described in section 511(a)(2)(B). However, an organization will not be regarded as operated exclusively if any part of its activities is in furtherance of a purpose other than supporting or benefiting one or more specified publicly supported organizations.

Section 1.509(a)-4(f)(4) of the regulations provides that in the case of supporting organizations which are 'operated, supervised, or controlled by' one or more publicly supported organizations, the distinguishing feature of this type of relationship is the presence of a substantial degree of direction by the publicly supported organizations over the conduct of the supporting organization, as described in paragraph (g) of this section.

Section 1.509(a)-4(g)(1)(i) of the regulations provides that each of the items 'operated by,' 'supervised by,' and 'controlled by,' as used in section 509(a)(3)(B), presupposes a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations. The relationship required under any one of these terms is comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization. This relationship is established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.

As indicated in the Revenue Rulings 85-1 and 85-2, supra, generally, the organizations engaged in activities that lessen the burdens of government, which have been recognized as exempt by the Service, have provided services and/or financial support directly or indirectly to the communities they serve. Therefore, if an organization provides services to a governmental unit to support the activities of such unit, including as in this case, the administration of the state's student financial aid programs and college savings programs, such support could be deemed to lessen the burdens of government and, therefore, satisfy the requirements for exemption under section 501(c)(3) of the Code.

M's organizing charter states that its purposes are to administer programs of student financial assistance for students attending public and private institutions in or outside of the State of Q and act as an agent in the administration of student financial assistance for local, state, or federal agencies approved by the board of trustees. Under an existing contract with N, M administers various state and federally funded student aid programs. The State of Q has indicated that it considers financial assistance and support for education beyond the high school level its burden through the establishment of N and O pursuant to Rev. Rul. 85-1. M will be responsible for the administration of O under a contract with N, an education assistance authority and an instrumentality of the State of Q. By providing administrative services for the operation of O, M is

lessening the burdens of government for the State of Q in its goal of providing financial assistance and support for students seeking education beyond the high school level pursuant to section 1.501(c)(3)-1(d)(2) of the regulations.

M's services under the contract to administer O will enable N and the State of Q to efficiently provide a means for parents and other interested parties to save for tuition and fees for higher education for selected beneficiaries. Such services will enable Q and N to make the O savings fund available to residents of the State of Q generally. Therefore, M's provision of administrative services for O under its contract with N contributes importantly to the accomplishment of M's stated purposes pursuant to section 1.513-1(d)(2) of the regulations.

Under M's organizing charter Q's governor and other state government officials are members of M and its principal incorporators. M's organizing charter also provides that the governor of Q has the power to appoint its trustees. M meets the requirements of section 509(a)(3) as a supporting organization, organized and controlled by Q's Office of the Governor, an organization described in section 509(a)(1), pursuant to section 1.509(a)-4(g)(1)(i) of the regulations.

M is operated to administer and support student financial aid programs offered through N and O. N is an instrumentality of Q and serves as Q's education assistance authority. O is a savings fund established by Q to permit parents and others to save for higher education expenses of their beneficiaries. By administering Q's student loan programs and savings program for higher education M is operated for the benefit of Q's Office of the Governor, N, and O pursuant to section 1.509(a)-4(e)(1) of the regulations.

Based on the above, we rule as follows:

- (1) The activities of M pursuant to its contract with N for O are substantially related to M's exempt purposes and do not adversely effect M's exempt status under section 501(c)(3) of the Code.
- (2) Income earned by M pursuant to its contract with N for O is not subject to tax under section 513 of the Code.
- (3) M meets the requirements as a supporting organization within the meaning of section 509(a)(3) of the Code.

Since you are terminating your status as private foundation by operating as a public charity during a 60-month period pursuant to section 507(b)(1)(B) of the Code, you will not incur

the termination tax imposed by section 507(c) pursuant to section 1.507-2(b)(2) of the regulations.

Section 1.507-2(d) of the regulations provides that in order to meet the requirements of section 507(b)(1)(B) of the Code for the 60-month termination period as an organization described in section 509(a)(3), you must meet the requirements of the provisions of that section for a continuous period of at least 60 months.

In order to comply with the requirements under section 507(b)(1)(B) of the Code, within 90 days after the end of your 60-month termination period you must furnish your key District office with information establishing that you did, in fact, operate as an organization described in section 509(a)(3) during such period. If you establish that fact, you will be so classified as long as you continue to meet the requirements of that section.

If you fail to satisfy the requirements of section 509(a)(3) of the Code for the continuous 60-month period, but you satisfy the requirements of section 509(a)(3) for any taxable year or years during such 60-month period, you will be treated as a public charity exempt under that section for such taxable year or years. Grants or contributions made during such taxable year or years shall be treated as made to an organization described in section 509(a)(3) of the Code. In addition, sections 507 through 509 and Chapter 42 shall not apply to you for any taxable year within such 60-month period for which you meet the requirements of section 509(a)(3).

Pursuant to section 1.507-2(a)(4) of the regulations, you cannot rely on this advance ruling to avoid the imposition of tax under section 4940 of the Code. Consequently, if you do not pay the tax imposed by section 4940 for any taxable year or years during the 60-month period, and it is subsequently determined that such tax is due for such year or years (because you did not complete a successful termination pursuant to section 507(b)(1)(B) and were not treated as an organization described in section 509(a)(3) for such year or years), you will be liable for interest in accordance with section 6601 for any amount of tax under section 4940 which has not been paid on or before the last date prescribed for payment. However, since any failure to pay such tax during the 60-month period (or prior to the revocation of this ruling) would be due to reasonable cause, the penalty under section 6651 with respect to the tax imposed by section 4940 shall not apply.

Although you are considered to be a public charity for certain purposes, you are still considered a private foundation

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for purposes of the filing requirements under sections 6033 and 6056. Accordingly, you must continue to file Form 990-PF for each year in the termination period. Check the block on Page 1 of the Form 990-PF indicating that you are a terminating private foundation. A copy of this letter should be attached to your Form 990-PF.

Donors (including private foundations) may rely on this ruling that you are not a private foundation until 90 days after the end of your 60-month period. However, if notice that you will no longer be treated as the type of organization indicated above is published in the Internal Revenue Bulletin, donors may not rely on this advance ruling after the date of such publication. Also, donors (other than private foundations) may not rely on the classification indicated above if they were in part responsible for, or were aware of, the act that resulted in your loss of that classification, or if they acquired knowledge that the Internal Revenue Service had given notice that you would be removed from that classification. Private foundations may rely on the classification as long as you were not directly or indirectly controlled by them or by disqualified persons with respect to them. However, private foundations may not rely on the classification indicated above if they acquired knowledge that the Internal Revenue Service had given notice that you would be removed from that classification.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based. Any changes that may have a bearing upon your tax status should be reported to the Service.

Except as we have ruled above, we express no opinion as to the tax consequences of your transaction under the cited provisions of the Code or under any other provisions of the Code.

In response to ruling requests 4 and 5, M has provided additional information indicating that it has not provided any loans or expended any funds attributable to its administration of O prior to July 1, 1998. Since M will operate as a public charity rather than a private foundation for a 60-month period commencing July 1, 1998, M will not be subject to taxes imposed under Chapter 42 on transactions occurring after that date with respect to its contract with N for the administration of O. Further, we conclude that it is not necessary to rule on requests 4 and 5 for periods prior to July 1, 1998 since M has not made any expenditures or loans under its contract with N for the administration of O, which would raise the issue of qualifying distributions under section 4942 or taxable expenditures under section 4945 of the Code for periods prior to July 1, 1998.

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This ruling does not purport to rule on whether O meets the requirements for exemption as a qualified state-sponsored prepaid tuition program described in section 529 of the Code.

This ruling is directed only to the organization that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

We are informing your key District Director of this ruling.

Sincerely yours,

Signed - Edward K. Karcher

Edward K. Karcher
Chief, Exempt Organizations
Technical Branch 3